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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1970

No. ~~1780~~ 70-236

ESTATE OF LILLIE MAC MUNN STEWART, Deceased,
W. ALAN HENDERSON, Executor,

*Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

## BRIEF FOR THE NEW YORK STATE BANKERS ASSOCIATION, TRUST DIVISION, AND THE CORPORATE FIDUCIARIES ASSOCIATION OF NEW YORK CITY, AS *AMICI CURIAE*, IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

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### Statement of Interest of *Amici Curiae*

The New York State Bankers Association, Trust Division,[1] and The Corporate Fiduciaries Association of New

[1] The New York State Bankers Association consists of 281 state and national banks and trust companies engaged in commercial banking activities in New York. Its Trust Division has 126 members, being virtually all of the banks and trust companies actively exercising personal trust powers in the state.

York City[2] appear herein as Amici Curiae, with the consent of the parties, in representation of the beneficiaries of the many trusts their members are now and hereafter will be administering that are adversely affected by the decision of the Court of Appeals for the Third Circuit in this case.

## Question in Issue

Whether charitable remainder gifts in trust after income interests are allowable charitable deductions under the various federal tax laws when the governing instrument gives the trustee more administrative discretion than state law alone would provide.

## Summary of Argument

As a result of a change in its interpretation of the law in 1960, the Internal Revenue Service has since then been denying deductions for remainder interests following income interests in trusts when the governing instrument gives the trustee more administrative discretions than state law alone would provide.

The Service's attack on the deductibility of charitable remainders following income interests succeeded in Congress in 1969. In the Tax Reform Act of 1969, Congress

[2] The Corporate Fiduciaries Association of New York City is comprised of trust companies, state and national banks maintaining trust departments or engaging in fiduciary transactions which have their principal offices in the City of New York. These are Bankers Trust Company, The Chase Manhattan Bank, N.A., Chemical Bank, Fiduciary Trust Company of New York, First National City Bank, Irving Trust Company, Kings Lafayette Bank, Manufacturers Hanover Trust Company, Marine Midland Grace Trust Company of New York, Morgan Guaranty Trust Company of New York, National Bank of North America, Schroder Trust Company, The Bank of New York, Underwriters Bank and Trust Company and United States Trust Company of New York.

permitted no estate, gift or income tax charitable deduction for a charitable remainder interest following an income interest in trust. Only remainders in "charitable remainder annuity trusts" and "charitable remainder unitrusts" are deductible under the new law. However, because of the equities involved, Congress made the new rules entirely prospective in operation. The case at bar and similar cases involve a retroactive application of the Service's changed interpretation.

This court should grant the petition for certiorari to resolve conflicts in already decided cases, to provide a rule of law for the proper disposition of numerous other cases now being disputed within the Internal Revenue Service and in the courts, and to prevent difficult and extensive future litigation in the federal courts.

Extensive future litigation will be avoided if the decision below is corrected. The additional discretions conferred in the governing instrument do not materially increase the power of the trustee to shift economic interest between the beneficiaries; the settlor evidenced no intent that these additional discretions should be exercised partially; and there is no reason to believe that the trustee will use them any less fairly and impartially than its other discretions. The Service's estate tax valuation tables, which assume that all the discretions of a trustee will be impartially and fairly exercised, are therefore applicable to value the charitable remainder in question, and it is "presently ascertainable" thereunder. As the chance that this charitable remainder will not become effective is so remote as to be negligible, its value is deductible.

## Argument

### Background

#### (1) A changed interpretation of the law by the Internal Revenue Service in 1960

This case is a product of a changed interpretation of the tax law by the Internal Revenue Service announced only by the issuance of Revenue Ruling 60-385, 1960-2 Cum. Bull. 77, which held that a charitable remainder interest in trust was not presently ascertainable and severable from the noncharitable income interest when capital gains dividends of regulated investment companies were allocable to income or could in the trustee's discretion be so allocated. Prior to that time, the Service had never intimated the slightest concern that the breadth of a trustee's administrative discretion or special allocation provisions in the governing instrument might affect deductibility. In fact, in Revenue Ruling 55-620, 1955-2 Cum. Bull. 56, which Revenue Ruling 60-385 overruled, the Service had specifically held that the remainder interest was deductible whether the capital gains dividends were allocable to principal or income.

Most of the cases that have been litigated up to now involve discretionary powers to allocate receipts and disbursements between principal and income. Sometimes these powers accompany broad investment powers, as in the case at bar. However, in *Doss* v. *United States*, Civil Action 5-693 (N.D. Tex. May 20, 1971), the deduction was disallowed by the Internal Revenue Service solely on the ground that the trustee's broad discretionary investment powers would enable her to invest in assets whose returns under the Texas Trust Act would be required to be apportioned in whole or in part to the income beneficiary.

It is only now apparent that the Service's policy since 1960, when it changed its interpretation of the law, has been to attack the deductibility of all charitable remainder interests preceded by income interests in trust, whenever the trustee has been given any more administrative discretion in the governing instrument than state law alone would confer.[3]

**(2) Congressional response to the Service's changed interpretation—The Tax Reform Act of 1969**

The Service's attack succeeded in Congress in 1969. The Tax Reform Act of 1969 allows no estate, gift or income tax charitable deduction for a remainder interest following an income interest in trust.[4] Such trusts will hereafter sometimes be referred to as "charitable remainder income trusts" in accommodation to the terminology used in the Tax Reform Act to refer to other kinds of charitable remainder trusts. For the remainder to be deductible

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[3] Revenue Ruling 60-385, *supra*, was issued in December 1960, seven months after the irrevocable trust agreements in the case at bar were executed. The Ruling was in terms applicable only to trusts made after 1960, so its precise holding with respect to capital gains treated as income is not applicable to Mrs. Stewart's trusts. A serious tax policy question exists whether the Service's changed interpretation of the law was so extreme that the Commissioner abused his discretion in failing to announce and explain it; also, in his failure to make it entirely prospective in operation. Many wills and trust agreements prepared in all good faith that became effective, or will become effective, between January 1, 1961 and October 9, 1972 and are now or will be in litigation would have been rewritten to conform to the changed rules if the draftsmen had only known new rules were in effect and what they were.

[4] Pub. L. No. 91-172, §201 (Dec. 30, 1969), 83 Stat. 549, enacting the following provisions of the Internal Revenue Code: *Estate tax*—Int. Rev. Code §2055(e)(2)(A). *Gift tax*—Int. Rev. Code §2522(c)(2)(A). *Income tax*—Int. Rev. Code §170(f)(2)(A). Remainder interests in so-called pooled income funds, which are entirely different from the private trust arrangements here involved, are also deductible.

under the new law, the precedent interest must be in the form of an annuity ("charitable remainder annuity trust") or in the form of a specified percentage of the value of the trust principal determined at least annually ("charitable remainder unitrust").[5] Use of a definite amount or a definite mathematical formula to determine the nonexempt beneficiary's interest was apparently designed to eliminate the trustee's discretion and, therefore, insure that charity would actually receive the full benefit of the deduction allowed.[6]

Unlike the Service, Congress made the new rules apply only prospectively for estate tax purposes—to trusts and wills of decedents dying after December 31, 1969, with a grace period for irrevocable trusts established on or before October 9, 1969 and revocable trusts and wills written on or before October 9, 1969 of settlors and testators who die before October 9, 1972 without changing or republishing them.[7] In adopting these effective dates, Congress unmistakably endorsed the continued deductibility of charitable interests in charitable remainder income trusts that became effective prior to January 1, 1970 or before the end of the grace period, if applicable.[8]

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[5] Charitable remainder annuity trusts and unitrusts are defined in new Int. Rev. Code §664.

[6] One cannot help commenting, however, that in the case of the charitable remainder annuity trust, the taxable annuitant seems to receive all the protection, the charity being more than ever dependent on the trustee to act for its benefit and make other than the most conservative kinds of investments.

[7] Pub. L. No. 91-172, §201(g)(4)(A)-(E).

[8] It is important in this connection that the Tax Court's decision below in favor of the taxpayer, 52 T.C. 830, which the entire Tax Court reviewed without dissent, was handed down on August 14, 1969. *Gardiner* v. *United States* (not officially reported), 69-2 U.S. Tax Cas. Para. 12,628, 24 Am.Fed. Tax R.2d 69-6108 (D. Ariz.) had previously been decided in taxpayer's favor, on May 21, 1969.

## The Present Chaotic State of the Law

It is apparent from the Service's zealous litigation of this and related cases, and its continuing administrative policy of denying the charitable deduction whenever the governing instrument grants the trustee any additional discretion over that provided by state law, that the Service is not satisfied with Congress' prospective application of its new interpretation of the law, but wishes it to be applied retroactively to as many charitable remainder income trusts as possible.

The government's success in the Court below has effectively frustrated the purpose of the grace period provided by Congress—to give affected taxpayers and their counsel reasonable time to familiarize themselves with the new law before requiring substitution of charitable remainder annuity trusts and unitrusts for existing arrangements. So strange and awkward are the new trust entities, and so technical and complex are the tax and administrative problems they create, that at this writing (June 2, 1971), final regulations have yet to be issued respecting them.

Thus, no estate planner at the present moment knows what either the old law or the new law is; and he cannot accommodate to the decision of the Court below by amending a pre-October 10, 1969 revocable trust or making a

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Thereafter, on September 2, 1969, *Miami Beach First National Bank* v. *United States* (not officially reported), 69-2 U.S. Tax Cas. Para. 12,627, 25 Am.Fed. Tax R.2d 70-1502 (S.D. Fla.), reversed, —— F.2d ——, 71-1 U.S. Tax Cas. Para. 12,744, 27 Am.Fed. Tax R.2d Para. 147,565 (5th Cir. 1971) was also decided for the taxpayer. No decision in any court favoring the Service's position was handed down until 1970. Hence, the law was wholly favorable to taxpayers when the grace period provisions were first added to the Tax Reform Act by the Senate Finance Committee in its bill introduced on November 21, 1969, and when the Tax Reform Act became law.

codicil to a pre-October 10, 1969 will, for that would take him out of the grace period. Only this Court's prompt review of the decision below will resolve the old-law part of his dilemma.[9]

## Reasons Why the Petition Should Be Granted

In its Petition, taxpayer cites several valid legal reasons, particularly a direct conflict between the decision of the Third Circuit in this case and the First Circuit's holding in *Old Colony Trust Company* v. *United States,* 423 F.2d 601, 70-1 U.S. Tax Cas. Para. 12,667, 25 Am.Fed. Tax R.2d 70-1549 (1st Cir. 1970). Our members fully subscribe to Petitioner's reasoning and conclusion. However, they have two particular duties to their beneficiaries that are here directly involved: first, their duty to keep trust administration expenses—specifically, litigation expenses—to a minimum; and second, their duty to resist illegal tax claims by litigation, if necessary. This brief accordingly stresses the need for prompt settlement of existing widespread controversy and avoidance of a large number of needless disputes in the future as the primary reasons why this Court should review the decision below.

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[9] If the decision of the Court below and the more recent decision of the Court of Appeals for the Fifth Circuit in *First National Bank in Palm Beach* v. *United States,* 71-1 U.S. Tax Cas. Para. 12,777 (5th Cir. May 7, 1971), are correct, the grace period was nothing but a trap for anyone who relied on it and died after October 9, 1969 and before January 5, 1971, the date of the decision below, leaving a will giving any extra discretion to the trustee.

**(1) Intervention by this Court is necessary to resolve conflicts in already decided cases and provide a rule of law for the proper disposition of other cases now being disputed in administrative proceedings within the Internal Revenue Service and in court**

As a result of the Service's general attack on charitable remainder income trusts, the decided cases involving the issue herein are already numerous:

*First Circuit:* The Tax Court decided against the government in a case involving broad discretionary allocation powers, applying Massachusetts law, in *Estate of Phyllis W. McGillicuddy,* 54 T.C. 315 (1970). The government did not appeal to the Court of Appeals which, however, cited the case with approval in *Old Colony Trust Company* v. *United States,* 423 F.2d 601, 70-1 U.S. Tax Cas. Para. 12,667, 25 Am.Fed. Tax R.2d 70-1549 (1st Cir. 1970). As petitioner states in the petition herein, the decision below conflicts directly with the *Old Colony Trust Company* case, the only possible distinction being a formal one that the cases arose under different sections of the estate tax law.

*Second Circuit:* Judge Lloyd F. McMahon ruled adversely to the government in a case that cannot successfully be distinguished from the case at bar, *Bankers Trust Co.* v. *United States,* 308 F.Supp. 545, 70-1 U.S. Tax Cas. Para. 12,653, 25 Am.Fed. Tax R.2d 70-1509 (S.D.N.Y. 1970—general discretionary powers under New York law), affirmed on another issue, 71-1 U.S. Tax Cas. Para. 12,748, 27 Am. Fed. Tax R.2d Para. 148,460 (2d Cir. 1971). The government not having chosen to appeal this issue in *Bankers Trust* case, Judge McMahon's ruling is the law in the Second Circuit.

*Third Circuit:* The case at bar. In addition, the Court of Appeals has before it on appeal *Peoples Trust Co. of Bergen County* v. *United States,* 311 F.Supp. 1197, 70-1 U.S. Tax Cas. Para. 12,658, 25 Am.Fed. Tax R.2d 70-1531

(D.N.J. 1970) (capital gains dividends from mutual funds —New Jersey law—held for taxpayer). Also arising under New Jersey law was *Marold* v. *United States,* 322 F.Supp. 664, 27 Am.Fed. Tax R.2d Para. 148,397 (D.N.J. 1970) involving broad discretionary allocation powers. The government did not appeal the court's decision in favor of the taxpayer.

*Fourth Circuit:* The government lost in *Greer* v. *United States,* 70-1 U.S. Tax Cas. Para. 12,690, 25 Am.Fed. Tax R.2d 70-1629 (M.D.N.C. 1970) (broad discretionary investment and allocation powers under North Carolina law). It did not appeal.

*Fifth Circuit:* In addition to *First National Bank in Palm Beach, supra,* the Court of Appeals has decided two other cases adversely to taxpayers, *Florida National Bank at Lakeland* v. *United States,* —— F.2d ——, 71-1 U.S. Tax Cas. Para. 12,771, 27 Am.Fed. Tax R.2d Para. 147,568 (5th Cir. April 26, 1971) (Florida law, capital gains to be included in distributions to income beneficiaries) and *Miami Beach First National Bank* v. *United States,* —— F.2d ——, 71-1 U.S. Tax Cas. Para. 12,774, 27 Am. Fed. Tax R.2d Para. 147,565 (5th Cir. April 30, 1971) (Florida law, capital gains dividends from mutual funds and broad discretionary apportionment powers.) Still another case has just been decided in this circuit in the taxpayer's favor, *Doss* v. *United States,* Civil Action 5-693 (N.D. Tex. May 20, 1971) (broad investment powers).

*Sixth Circuit:* The taxpayer won in *Estate of Toulmin* v. *United States,* —— F.Supp. ——, 71-1 U.S. Tax Cas. Para. 12,775, 27 Am.Fed. Tax R.2d Para. 147,560 (S.D. Ohio, March 19, 1971) (general discretionary allocation powers under Ohio law). Whether the government will appeal has not been announced.

*Ninth Circuit:* On appeal to the Court of Appeals is *Gardiner* v. *United States* (not officially reported), 69-2 U.S. Tax Cas. Para. 12,628, 24 Am.Fed. Tax R.2d 69-6108 (D. Ariz. May 21, 1969) (Arizona law, general discretionary allocation powers—held for taxpayer).

Our members are parties to many similar cases and have heard of numerous others throughout the country that are pending in the Tax Court and the District Courts or are being considered at some administrative level within the Internal Revenue Service. There is more than sufficient conflict, confusion and volume of decisions to warrant this Court's grant of certiorari.

**(2) Intervention by this Court is necessary to prevent difficult and extensive future litigation in the federal courts**

This Court should also consider the future effects of the decision below upon the administration of justice by the District and Circuit courts, for unlike this Court, they may not decline to hear cases properly brought. If the decisions of the Courts of Appeals for the Third and Fifth Circuits stand, and if the Internal Revenue Service continues to disallow charitable deductions wherever conceivable, the federal courts will be inundated by a flood of these charitable deduction cases. It will be necessary for them to try to develop, case by case, rules for determining what, if any, deviations from state laws, discretionary or otherwise, are permissible. The fact that the grant of discretion to trustees is common, that few lawyers draft identical trust agreements, that the possible deviations and combinations of deviations from 51 different bodies of local law are innumerable, and that millions of dollars of taxes and correlative losses to charity will be at stake to give impetus to litigation, makes the prospect alarming.

The charitable deduction provisions in the federal statutes demand uniformity of application throughout the country. Because of this, it does not seem possible simply to hold that any deviation from local law is automatically fatal to deductibility. Why, if the quantum of the gift to charity is the same, should a resident of one state have the benefit of the charitable deduction, and a resident of another state be denied it? Accommodating to all the state law differences on a case by case basis is a difficult and time-consuming prospect. Adoption of federal standards would be no easier in view of the wide and irreconcilable differences of opinion of informed lawyers, judges and legislators as to what constitutes principal and what constitutes income. Such intellectual exercises would in a sense be wasted, for they would have no value for the future, all the governing instruments that could be involved having already been written.[16]

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[16] The Fifth Circuit's opinion in the *First National Bank in Palm Beach* case, *supra*, provides three perfect illustrations of the problems mentioned. First, non-amortization of premiums paid on the purchase of bonds, as directed by the will, which the government in its brief and Judge Tuttle in his opinion cited as impermissible invasions of the charitable remainder interest, is the law in Florida, Fla. Statutes Ann., §690.07. In common with many other states, Florida adopted this rule in enacting the Uniform Principal and Income Act. See §6 of that Act and §7 of the Revised Uniform Principal and Income Act. Either both the government and Judge Tuttle were mistaken as to Florida law in this respect, or some sort of federal standard was being used. Judging from the tone of the Court's opinion, the latter explanation seems at least partially correct. Next, the executors had full authority, wrote the court, "to treat stock dividends . . . as income rather than as accretions to corpus, which they really are. It is recognized in the Florida law and the Uniform Principal and Income Act, Florida Statutes Annotated §690.06, that 'stock dividends should inure to the benefit of the corpus'. Stock dividends, of course, are merely a redistribution of the number of shares representing the assets of a corporation. Certainly, to the extent that stock dividends represent appreciation in the value of the underlying assets of the corporation, rather than income to it they represent accretions to principal." —— F.2d. ——, 71-1 U.S. Tax Cas. Para. 12,777 at 9047-75. This is the so-called

Finally, the issue in this case is not restricted to a relatively small group of estate and gift tax cases. No measurable portion of capital gains realized during the administration of a trust and allocated to principal can be said to be "permanently set aside for" charitable purposes, as the income tax statute, §642(c) of the Code requires, if the trustee may invest the gains in wasting assets and allocate the receipts to income, as the court below found to be a "possibility."

The issue in this case, then, affects the taxation of at least a substantial fraction, and perhaps even a majority of thousands of existing split-interest trusts to which the Tax Reform Act of 1969 does not apply. This case is of enormous practical importance not only to the public fisc but also to the charitable community on which the ultimate burden is going to fall. It involves a conflict of basic trust principles and basic tax policies of such importance and complexity that only this Court can resolve them and it should undertake to resolve them.

## The Merits of Petitioner's Case

The probability of petitioner's success upon a full hearing may possibly be considered a relevant factor in determining whether to grant its petition for certiorari. Accordingly, a brief discussion of the merits of the case is now submitted.

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Massachusetts rule. Yet many states follow the Pennsylvania rule, under which stock dividends are treated as income insofar as they do not impair the "intact value" of the shares when acquired by the trust. See III Scott on Trusts §§236.3, 236.6 (3d Ed. 1967). Finally, the Court stated with respect to liquidating dividends, "Obviously, the distribution of a dividend by distributing the assets of a corporation on its dissolution is a distribution of principal." (Id.) Yet the states following the Pennsylvania rule also hold liquidation proceeds apportionable in the same way as extraordinary cash and stock dividends. III Scott on Trusts, §236.10.

Two unstated and erroneous assumptions underlie the decisions of the Courts of Appeals for the Third and Fifth Circuits: First, that the discretionary powers granted in the governing instruments increase to a material or significant degree the trustee's ability to shift economic benefits from principal to income. Second, that the tables prescribed by the Service for valuing trust interests are based on some known, definite formula for valuing such interests.

**(1) The additional discretions conferred do not materially increase the power of the trustee to shift economic interests between the beneficiaries**

The extent to which economic interests can be shifted under discretionary apportionment powers such as those considered by the two Courts of Appeals is insignificant, compared to the power of every trustee to shift by investment choices. Professor Scott cites investment powers to support his statement that "The trustee . . . ordinarily has considerable discretion in preserving the balance between the beneficiaries." III Scott on Trusts §232 (3d Ed., 1967).[11]

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[11] Professor Scott's complete statement is as follows:

> "The trustee, however, ordinarily has considerable discretion in preserving the balance between the beneficiaries. The beneficiary entitled to the income cannot insist that the trustee should invest in securities yielding the highest rate obtainable from proper trust investments, nor on the other hand can the beneficiary entitled to the principal insist that the trustee should invest only in the very safest and most conservative of trust investments, as for example in government bonds. Indeed, if the trustee invests the whole of the trust funds in government bonds at a time when the income thereon is very small, he may conceivably be held liable to the beneficiary entitled to the income on the ground that he has unduly favored the remainderman. There is, however, no absolute rule on this matter and under some circumstances such conduct of the trustee might be justified." III Scott on Trusts, §232, p. 1896 (3d Ed., 1967).

A concrete example will demonstrate this point better than general language. On a recent date, American Telephone and Telegraph Company 7.75s of 1977 closed at 104⅝, and that Company's 2¾s of 1975 closed at 85¼.[12] These two issues are obviously equal in quality and mature in the relatively near term within two years of each other. Although their yields to maturity are approximately the same, an investment of $89,200[13] in the one or the other will, if the bonds are held to maturity, have the following widely different consequences for principal and income under the Revised Uniform Principal and Income Act §7, which has been adopted by New York in EPTL §11-2.1(f) and by most other states:

| *Issue Purchased* | *Annual Interest Allocable to Income* | *Capital Gain (Loss) to Principal at Maturity* |
|---|---|---|
| 7.75s of 1977 | $6,587 | ($ 3,981) |
| 2¾s of 1975 | $2,860 | $15,340 |

Which issue should be bought? Perhaps one, perhaps the other, perhaps neither, perhaps some of both (to offset any loss to principal) or perhaps some of the 7.75s and some I.B.M. stock. The trustee's decision will depend on a variety of factors, including the makeup of the investment portfolio as a whole, the trustee's evaluation of general economic conditions, and his duty to be impartial as between principal and income beneficiaries. But whatever

[12] Quotations are for May 20, 1971 as reported in the Wall Street Journal of May 21, 1971.

[13] For purposes of the example, it has been ignored that bonds are not traded in units of less than $1,000 face amount.

investment decision the trustee does make, he necessarily favors one class of beneficiaries over the other.[14]

Obviously, if trustees can be relied on to be impartial in investing, as they must be, trustees can also be relied upon to be impartial in making far less sophisticated and relatively inconsequential apportionment decisions, when any actual bias would be far more evident. It is also apparent that investment decisions and apportionment discretions are interrelated. In the A T & T obligations example, the trustee would feel freer to buy the 7.75s if he had the discretion to amortize the premium that the trustee has in the case at bar.

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[14] Professor Bogert uses the following language to make the same point:

> "The duty to deal impartially between income and principal beneficiaries cannot be measured precisely as to each investment transaction, for each transaction, considered by itself, will at least slightly favor one or the other beneficiary. This does not mean that a breach of trust is involved. Neither the prudent man rule nor the duty of impartiality requires that each investment transaction be considered independently of other investment transactions during the current year, or of investment results in prior years, or, for that matter, apart from investment planning for the future. For these reasons a trustee's investment actions necessarily must be judged over a period of time, upon the basis of other factors discussed in this section, and by considering related investment transactions already made and those proposed to be made. The prudence of a sale of a particular trust asset should be judged both as an independent action and as part of a larger investment transaction involving the reinvestment of the sale proceeds, under current market conditions.
>
> "Each proposed investment transaction should be weighed with a view to the overall relative positions of the income beneficiary and remaindermen and the effect of the proposed transaction on those positions." Bogert, The Law of Trusts and Trustees, §612 at 47 (2d Ed., 1960, Supp. 1970).

**(2) The Service's valuation tables are not specially designed for valuing trust interests. They are validly used for that purpose only because it is assumed that trustees' discretions will be impartially and fairly exercised. Only on this assumption is the value of any charitable remainder interest "presently ascertainable"**

The second unstated and erroneous assumption of the Courts of Appeals is that the term "presently ascertainable", as used in the regulations, means "accurately calculable" or "measurable" when applied to interests in trust. The denial by Revenue Ruling 60-385, 1960-2 Cum. Bull. 77, *supra,* of a deduction when capital gains dividends of investment trusts may be allocated to income "since no known formula has been advanced for ascertaining the value of the charitable interest" implies that there is some such formula that the Internal Revenue Service uses to value ordinary trust income and remainder interests. Nothing could be further from the truth. The valuation formula used is nothing more special than compound interest tables combined with actuarial factors. These tables accurately value at 6% interest compounded annually (formerly at 3½% interest, compounded annually), fixed returns on money, annuities in fixed amounts, fixed sums of money payable at the end of a life and other definite payments, but they have nothing whatever to do with valuing trust interests that are dependent on the discretion of trustees. They make no adjustment for factors peculiar to trusts that have an effect on the value of interests therein. The Internal Revenue Service has informally declined on the basis of administrative convenience to consider making any sort of adjustment to reflect the fact that 6% is from 40% to 50% higher than trustees are usually able to realize for income beneficiaries. Their duties to remaindermen require them to accept a low yield on some investments. And, of course, the government's tables are completely oblivious

to the substantial differences in value of income interests in different jurisdictions adhering to the widely dissimilar Pennsylvania and Massachusetts stock dividend allocation rules.

Thus, valuation of trust interests for federal tax purposes is of a most approximate kind, completely ignoring the broad discretionary powers all trustees have. The prescribed tables apply to trusts only because the Internal Revenue Service says they do. Their application to trust interests is valid only on the assumption that the trustees' discretions will in fact be exercised fairly, sometimes in favor of the income beneficiary, no doubt, and sometimes in favor of the remaindermen, but even-handedly over-all. Only on this assumption is the value of any charitable remainder interest "presently ascertainable."

**(3) The additional discretions conferred are not intended to favor the income beneficiaries over the charitable remaindermen. There is no reason to believe they will not be impartially and fairly exercised**

The Court of Appeals for the Fifth Circuit also based its *First National Bank in Palm Beach* decision in part on the following false legal conclusion:

> "We have stated in the case of *The Miami Beach First National Bank* v. *United States of America,* [7-1 U.S. Tax Cas. Para. 12,776, 27 Am.Fed. Tax R. 2d Para. 147,565], it is clear that when extraordinary powers of this kind are given to the fiduciary they are intended to modify the general rule with respect to the obligations to a fiduciary to deal with an even hand with respect to the life tenant as against the remainderman when no such extraordinary powers are expressed." —— F.2d ——, 71-1 U.S. Tax Cas. Para. 12,777 at 9047-76.

The Court assumed the wrong answer to the very point to be decided. Whether the grant of extraordinary discretionary powers is made with such intent is not determinable *a priori,* but is a question of interpretation of the governing instrument.

If there is such intent, then the even-handed and balanced exercise of discretion assumed in the valuation tables would be upset; otherwise, it would not, and use of the tables would still be valid. In the case at bar, there is manifestly no intent to upset the balance. The discretionary powers were not written specially by the settlor but were the 1960 version of "model powers" prepared for the convenience of attorneys by one of our members, Manufacturers Hanover Trust Company, to give it sufficient discretion to handle the allocation questions that always arise in the administration of trusts in a practical as well as a fair way without having to go to court for instructions or approval. These "model powers" are in the governing instruments of numerous other trusts now being administered by that Company, some having charitable beneficiaries as in the case at bar. Many other members of our organizations have developed their own "model powers" that differ in detail but not in substance or purpose from Manufacturers Hanover's. These powers are not designed to and do not favor either principal or income, giving discretions the exercise of which would sometimes benefit the one and sometimes the other.[15]

[15] The discretion to invest in investment trusts and wasting assets, which would normally benefit income, is balanced by the discretion to hold trust property uninvested without liability or loss to income. Also, the power to allocate payments in respect of wasting assets to income is offset by the discretion to allocate payments in respect of unproductive property to principal. Similarly, the determination of whether to discontinue any sinking fund is balanced by the authority to amortize bond premiums and the implied power to establish depreciation and depletion reserves. The

To be contrasted are discretionary powers that are in fact designed to favor one class of beneficiaries over the other. The governing instrument may expressly authorize invasions as in *Henslee* v. *Union Planters Bank*, 335 U.S. 595 (1949), *Merchants National Bank* v. *Commissioner*, 320 U.S. 256 (1943) and *Ithaca Trust Company* v. *United States*, 279 U.S. 151 (1929). Or the governing instrument may direct the trustee to exercise the discretions in such a way as to favor the income beneficiaries or direct or permit such extreme deviations from established concepts of what constitutes principal and income as to upset the balance directly or to manifest an intention that the trustee need not act impartially.[16] The governing instrument in *Florida National Bank at Lakeland* v. *United States*, —— F.2d ——, 71-1 U.S. Tax Cas. Para. 12,771, 27 Am.Fed. Tax R.2d Para. 147,568 (5th Cir. 1971), in which the trustee was directed to distribute income and capital gains to the income beneficiaries, appears to fall within this classification. Such provisions are really dispositive provisions and not mere broadenings of administrative discretions.

The instruments in the other two recent cases of the Court of Appeals for the Fifth Circuit, *Miami Beach First National Bank* v. *United States*, —— F.2d ——, 71-1 U.S. Tax Cas. Para. 12,774, 27 Am.Fed. Tax R.2d Para. 147,565 (5th Cir. 1971), and *First National Bank in Palm Beach* v. *United States*, —— F.2d ——, 71-1 U.S. Tax Cas. Para. 12,777 (5th Cir. 1971) evidence no intent to and do not up-

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rule authorizing the trustee to apportion accrued income at termination to the remaindermen could benefit only the charity-remaindermen.

[16] Cf. Taggart, *Charitable Deductions for Transfers of Remainder Interests Subject to Invasion*, 21 Tax L. Rev. 535, 572 (1966).

set the traditional balance.[17] The broad administrative discretions provided in them and in the case at bar have many times been held intended to benefit both principal and income, and not to be exercisable in a partial way. Two excellent and well-known recent formulations of the rule are those of the highest courts of Massachusetts and Connecticut:

> "We think the grant of power to 'decide whether accretions' are to be treated as principal or income and how expenses are to be charged, apart from its possible exculpatory effect, is primarily an administrative power authorizing the trustee in instances of doubt to use its best informed judgment in good faith in the light of what the established rules suggest to the trustee is consistent therewith. This is a means of avoiding the expense of litigation. This power may not be used to shift beneficial interests. It does not authorize favoring either the charitable or the private beneficiaries. It is of equal advantage to each in conserving the as-

[17] Allocating capital gains dividends of regulated investment companies to income, an issue in the *Palm Beach* case, would not necessarily cause an imbalance. It is the Internal Revenue Service's opposite and arbitrary rule requiring allocation to corpus that is more likely to upset the balance by unduly favoring the charitable remaindermen. See Bogert, The Law of Trusts and Trustees, §612 at 52-53 (2d Ed. 1960, Supp. 1970):

> "A clear case of partiality in connection with investments would seem to exist where the trustee buys shares in an investment trust and under the applicable law capital gains distributions by the investment trust are required to be treated as trust capital. Here the trustee is taking subnormal income yield and securing additions to trust capital and not merely the maintenance of it. Instead of buying an ordinary legal and getting perhaps 4½% income and the mere maintenance of the corpus of the trust, he is getting something like 2.8% income from the investment trust and 2.3% capital gains distributions which go to increase the value of the trust capital. The percentages used are taken from the report for 1960 made by the national association of investment trusts."

sets of the trust. In our view such a power imports no more uncertainty in the ascertainment and calculations of the value of the charitable remainders than does the contingency that the precise amount of administrative charges and of accretions over the years cannot be known in advance." *Old Colony Trust Company* v. *Silliman,* 352 Mass. 6, 11-12, 223 N.E. 2d 504, 507-08 (1967).

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". . . there can be no doubt that the trustees are given no dispositive, as distinguished from administrative, powers and that they cannot, under settled law prevailing not only in Connecticut but elsewhere, exercise any of their powers for the purpose (even if well-intended) of materially altering the value of the beneficial interests under the Oakwood trust to the detriment of Oakwood as an income beneficiary. To hold otherwise would permit the trustees to give Oakwood's income in whole or in part to the beneficiaries of the Connor trust under the motivation of a purpose and desire to enrich the Connor trust at the expense of the Oakwood trust.

• • •

"The administrative powers to determine what is principal and what is gross and net income and to allocate charges to either income or principal or both are powers often conferred in wills and here were included in a number of other administrative powers grouped together generally in Article Sixteenth of the will. It certainly would constitute a violent and wholly unwarranted repudiation and reversal of heretofore settled Connecticut trust law to construe any or all of these administrative powers conferred on the trustees as powers which, separately or collectively,

authorized the trustees to destroy or cripple a charitable bequest and turn Oakwood's income over, in whole or in part, to the Connor trust, thus in effect nullifying the whole charitable purpose of the second codicil and leaving the original will as though that codicil had never existed. For the trustees so to do would be an impermissible and illegal abuse of discretion and would obviously be in violation of the settled rule that '[w]hen there are two or more beneficiaries of a trust, the trustee is under a duty to deal impartially with them.' Restatement (Second), 1 Trusts §183. The Oakwood trust is a clear gift of 'the net income' of the trust corpus to an admitted charity. Equity would interfere to protect this charitable gift from impairment or destruction by the trustees or anyone else." *Connor* v. *Hart*, 157 Conn. 265, 273-76, 253 A.2d 9, 13-15 (1968).

New York law is clearly the same.[18]

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[18] See *Bankers Trust Co.* v. *United States*, 308 F.Supp. 545 (S.D.N.Y. 1970), *supra*; *Matter of Heinrich*, 195 Misc. 803, 90 N.Y.S.2d 805 (Sur. Ct. Monroe Co. 1949), cited with approval by the Court of Appeals in *Matter of Muller*, 24 N.Y.2d 336, 341, 248 N.E.2d 164, 166 (1969). That the adoption by New York of the Revised Uniform Principal and Income Act §2, now N.Y. EPTL §11-2.1 did not change the rule of *Matter of Talbot*, 170 Misc. 138, 9 N.Y.S.2d 806 (Sur. Ct. Orange Co. 1939), as the Court below seems to have thought, see *Estate of Frank*, N.Y.L.J. Feb. 24, 1971 at 20, col. 3 (Sur. Ct. N.Y. Co.) which involved a provision giving the executors power to "determine what is income and what is principal hereunder; and their decision in respect thereto shall be conclusive upon all parties". The Surrogate stated: "The authorization to the fiduciaries to determine what is income and what is principal is a grant of discretion to resolve matter of doubt arising from the receipt of money, stocks or securities which may either be capital or income." EPTL §5-1.1 was not enacted to prevent interference with the income of a surviving spouse by reason of the breadth of the fiduciary powers in §11-2.1, as the Court below seems to have thought, but was simply a re-enactment of a provision first added to the New York statutes in 1936, L. 1936, c. 234—long before the enactment of the EPTL—to overrule a specific decision, *Matter*

Granting discretionary powers in the governing instrument in addition to those conferred by state law as a means of facilitating the administration of trusts for the benefit of all beneficiaries thereof is in line with a now long-established trend throughout the country, clearly apparent in the steady liberalization of trust investment rules, of giving trustees ever more discretion.[19] This trend reflects a uniform judgment by the states, founded on experience, that trustees do faithfully and fairly execute the discretionary powers entrusted to them, and that the interests of all trust beneficiaries, charitable and non-charitable alike, are better served by reposing more, rather than less, confidence in them. There is no reason to believe the trustee will not exercise the discretionary powers here conferred on it other than impartially and fairly.

**(4) The chance that the charitable remainder here in question will not become effective is so remote as to be negligible. Its value is deductible**

Neither the government nor the court below ever asserted that there was any real likelihood that the charitable

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*of Curley,* 245 App. Div. 255, 280 N.Y.S. 80 (2d Dept., 1935), aff'd without opinion, 269 N.Y. 548, 199 N.E. 665 (1935), which the Court of Appeals itself disavowed a year later in *Matter of Clark,* 275 N.Y. 1, 9 N.E.2d 753 (1937).

[19] In fact, Virginia now provides broad discretionary powers in statutory provisions that can be incorporated by reference in the governing instrument. The allocation power in Va. Code §64.1-57 (Supp. 1970) is as follows:

> "(1) The following powers in addition to all other powers granted by law may be incorporated, in whole or in part in any will or trust instrument by reference to this section:
>
> * * *
>
> "(il) To determine whether any part of the trust estate or any addition or increment hereto be income or principal, or whether any cost, charge, expenses, tax or assessment shall be charged against income or principal, or partially against income and partially against principal."

remaindermen in this case will not in fact receive the gift Mrs. Stewart intended to give. The complaint of the Service is that it has no way of computing the value of the "possibility" the charities will receive less; but it is equally impossible for it to compute the value of the at least equal "possibility" that the charity will receive more. *United States* v. *Provident Trust Co.*, 291 U.S. 272 (1934) stands for the principle that the tax law must be applied in a realistic and not a theoretical way where, as here, a legislative policy to encourage charitable gifts is involved. The chance that the charitable remainder interest here in question will not become effective is so remote as to be negligible and its value is therefore deductible. *Commissioner* v. *Sternberger's Estate*, 348 U.S. 187, 193 (1955).

## CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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